APPENDIX

Revenue Act of 1926, 44 Stat. 9:

DEDUCTIONS ALLOWED INDIVIDUALS

SEC. 214. (a) In computing net income there shall be allowed as deductions:

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(9) In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. In the case of leases the deduction allowed by this paragraph shall be equitably apportioned between the lessor and lessee;

SEC. 204. * * *

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(c) The basis upon which depletion, exhaustion, wear and tear, and obsolescence are to be allowed in respect of any property shall be the same as is provided in subdivision (a) or (b) for the purpose of determining the gain or loss upon the sale or other disposition of such property, except that—

* * * * *

(2) In the case of oil and gas wells the allowance for depletion shall be 27½ per centum of the gross income from the property during the taxable year. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in

no case shall the depletion allowance be less than it would be if computed without reference to this paragraph.

Revenue Act of 1936, 49 Stat. 1648:

SEC. 22. GROSS INCOME.

(a) GENERAL DEFINITION.—"Gross income" includes gains, profits, and income derived from * * * dealings in property * * * and income derived from any source whatever. * * *

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

* * * * *

(m) *Depletion.*—In the case of mines, oil and gas wells, other natural deposits, and timber, a reasonable allowance for depletion and for depreciation of improvements, according to the peculiar conditions in each case; such reasonable allowance in all cases to be made under rules and regulations to be prescribed by the Commissioner, with the approval of the Secretary. * * *

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PART IV.—*Accounting Periods and Methods of Accounting.*

SEC. 41. GENERAL RULE.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in section

48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year. (For use of inventories, see section 22 (c).)

SEC. 42. PERIOD IN WHICH ITEMS OF GROSS INCOME INCLUDED.

The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. In the case of the death of a taxpayer there shall be included in computing net income for the taxable period in which falls the date of his death, amounts accrued up to the date of his death if not otherwise properly includible in respect of such period or a prior period.

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SEC. 114. BASIS FOR DEPRECIATION AND DEPLETION.

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(b) *Basis for depletion.*—

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(3) *Percentage depletion for oil and gas wells.*—In the case of oil and gas wells the allowance for depletion under section 23 (m) shall be 27½ per centum of the gross income from the property during the taxable year, excluding from such gross income an amount equal to any rents or royalties paid or incurred by the taxpayer in respect of the property. Such allowance shall not exceed 50 per centum of the net income of the taxpayer (computed without allowance for depletion) from the property, except that in no case shall the depletion allowance under section 23 (m) be less than it would be if computed without reference to this paragraph.

* * * * *

Treasury Regulations 69, promulgated under the Revenue Act of 1926:

ART. 216. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—(a) Where a lessor receives a bonus in addition to royalties, there shall be allowed as a depletion deduction in respect of the bonus an amount equal to that proportion of the cost or value of the property on the basic date which the amount of the bonus bears to the sum of the bonus and the royalties expected to be received. Such allowance shall be deducted from the amount remaining to be recovered by the lessor through depletion, and the remainder is recoverable through depletion deductions on the basis of royalties thereafter received.

(b) Where the owner has leased a mineral property for a term of years with a requirement in the lease that the lessee shall extract and pay for, annually, a specified number of tons, or other agreed units of measurement, of such mineral, or shall pay, annually, a specified sum of money which shall be applied in payment of the purchase price or royalty per unit of such mineral whenever the same shall thereafter be extracted and removed from the leased premises, the value in the ground to the lessor, for purposes of depletion, of the number of units so paid for in advance of extraction will constitute an allowable deduction from the gross income of the year in which such payment or payments shall be made; but no deduction for depletion by the lessor shall be claimed or allowed in any subsequent year on account of the extraction or removal in such year of any mineral so paid for in advance and for which deduction has once been made.

(c) If for any reason any such mineral lease shall be terminated or abandoned before the mineral which has been paid for in advance has been extracted and removed, and the lessor repossesses the leased property,

the lessor shall adjust his capital accounts by restoring to the capital sum of the property the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and his income account shall be adjusted so as to include the amount so restored to capital sum as income of the year such lease is terminated or the property repossessed, and the tax thereon paid.

(d) Upon the expiration, termination, or abandonment of the lease, without the removal of any or all of the mineral contemplated by the lease, the lessor shall be required to restore to capital account the excess of the depletion theretofore allowable in respect of the bonus and royalty payments over the actual depletion or loss in value sustained as a result of the operations under the lease, and a corresponding amount must be returned as income for the year in which the lease expires, terminates, or is abandoned.

(e) [This paragraph is quoted *supra*, p. 5.]

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ART. 221. *Depletion in the case of oil and gas wells.*— * * * In general, "the property," as the term is used in section 204 (c) (2) and this article, refers to the separate tracts or leases of the taxpayer.

Treasury Regulations 94, promulgated under the Revenue Act of 1936:

ART. 23 (m)–10. *Depletion—Adjustments of accounts based on bonus or advanced royalty.*—* * *

* * * * *

(c) If for any reason any such mineral lease expires or terminates or is abandoned before the mineral which has been paid for in advance has been extracted and removed, the lessor shall adjust his capital account by restoring thereto the depletion deductions made in prior years on account of royalties on mineral paid for but not removed, and a corresponding amount must be re-

turned as income for the year in which the lease expires, terminates, or is abandoned.

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G. C. M. 14,448, XIV–1 Cum. Bull. 98, 100–101 (1935):

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In its opinion in *William E. Herring* v. *Commissioner, supra,* the Supreme Court made the statement that it expresses no opinion as to whether the amount allowed as a depletion deduction from the bonus payment in the year of the execution of the lease may be taxed as income to the lessor in the year of the termination of the lease where there has been no extraction of mineral from the leased premises. The allowance of the deduction in the year of the execution of the lease rests upon an anticipation of production to avoid "the attendant inconvenience of indefinite postponement," as was said in *Murphy Oil Co.* v. *Burnet, supra.* The grant of the deduction is in any case upon the ground of "a reasonable allowance for depletion." If on the termination of the lease there has been no production, then there has in fact been no depletion. Ordinarily the Government may recoup only by restoring the deduction to income and asserting the tax against the taxpayer in the year of the termination of the lease. *Cost* depletion on an advance royalty has always been allowed on condition that if the anticipated production does not materialize, the taxpayer will restore the amount of the deduction to income as of the year the lease terminates, expires, or is abandoned. (See article 216 (b) and (c), Regulations 69, with which all prior and subsequent regulations are identical.) Since the "nature and purpose of the allowance is the same," as the Supreme Court has pointed out, whether the deduction be computed on the cost basis or on a percent of the gross income from the property, it follows that the taxpayer must be deemed

to have taken the bonus depletion deduction on the percentage of income basis on the condition that he will restore the amount of such deduction to income as of the year of the termination of the lease where there has been no production from the leased premises.

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